T.C. Memo. 2010-230

UNITED STATES TAX COURT

CAROL D. ANDREWS, DECEASED, ROBERT ANDREWS, SUCCESSOR IN
INTEREST, AND ROBERT ANDREWS, Petitioners <u>v</u>.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 23540-07.   Filed October 21, 2010.

<u>Terri A. Merriam</u>, <u>Marlyn P. Chu</u>, <u>Jaret R. Coles</u>, and <u>Adam J. Blake</u>,[1] for petitioners.

<u>Nhi T. Luu</u>, for respondent.

MEMORANDUM OPINION

KROUPA, <u>Judge</u>: This case is one of seven pending affected item proceedings involving separate allocation of section 6662

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[1]Marlyn P. Chu, Jaret R. Coles, and Adam J. Blake filed motions to withdraw as petitioners' counsel. We granted all three motions.

accuracy-related penalties under section 6015(c) (separate

liability allocation).[2] The taxpayers in each of the pending

cases were investors in Hoyt cattle partnerships subject to the

provisions of the Tax Equity and Fiscal Responsibility Act of

1982 (TEFRA), Pub. L. 97-248, sec. 402, 96 Stat. 648. The

parties in each of the pending cases have agreed that this case

and Malsom v. Commissioner, T.C. Memo. 2010-231, also filed

today, will be used to present the penalty allocation issue to

the Court.[3]

     The parties filed a Stipulation of Settled Issues at trial

that resolved all issues except the computation of petitioner's

separate liability allocation. The parties agree that Robert

Andrews (petitioner) and his late spouse, Carol D. Andrews (Mrs.

Andrews), are liable for the accuracy-related penalties for 1994,

1995 and 1996 (the years at issue) and they agree that petitioner

is entitled to the separate liability allocation for each year at

issue. They also agree that the computational methodology

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     [2]All section references are to the Internal Revenue Code.

     [3]The parties chose Andrews and Malsom because they represent
two distinct scenarios. The requesting spouse in Malsom is the
spouse who earned the higher income during the years at issue
while the requesting spouse here earned the lower income.
Respondent's proposed methodology benefits the requesting spouse
in Malsom but does not benefit the requesting spouse here.
Nevertheless, the parties agree that the same computational
methodology should be used in all cases for consistency. We will
therefore apply the same methodology in Andrews, Malsom, and the
other pending cases.

established in <u>Estate of Capehart v. Commissioner</u>, 125 T.C. 211
(2005) (<u>Capehart Estate</u> methodology), should be applied to
determine petitioner's separate liability allocations. There is
no dispute as to the liability for each year at issue. The
parties disagree, however, on how the liabilities and the
penalties should be allocated when there are multiple sets of
computational adjustments to petitioner's liability for each
year. There are two sets of computational adjustments for each
year because petitioner and Mrs. Andrews were partners in
multiple TEFRA partnerships, the Tier 1 and Tier 2 partnerships,
during the years at issue.[4] The Tier 2 partnerships were also
partners in the Tier 1 partnership. Petitioners reported
partnership losses from both the Tier 1 and Tier 2 partnerships
on the joint returns for the years at issue.

The parties' disagreement focuses on the timing of the
computations. Respondent's proposed computations make the Tier 1
and Tier 2 computational adjustments for each year in two

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[4]Petitioner and his late spouse were partners in two
partnerships, Durham Genetic Engineering 1984-2 and Durham
Genetic Engineering 1985-4 (Tier 2 partnerships), during the
years at issue. The Tier 2 partnerships were also partners in
upper tier Hoyt partnerships (Tier 1 partnerships). Tier 1
partnership losses flowed through the Tier 2 partnerships to
petitioner and Mrs. Andrews. Petitioner and Mrs. Andrews
reported partnership losses from both the Tier 1 and Tier 2
partnerships on the joint returns for the years at issue.

separate steps.[5] In contrast, petitioner's proposed computations

make the Tier 1 and Tier 2 computational adjustments in one step.

Applying the computations in one step as petitioner proposes

results in one deficiency and one penalty for each of the years

at issue.[6] Applying the computations in two steps as respondent

proposes results in two separate sets of deficiencies and

penalties for each year. The allocated amounts are also

different when the computations are made in two steps rather than

together in one step. We agree with respondent that the

computations for each TEFRA partnership must be made separately

before the liabilities and penalties are allocated under the

Capehart Estate methodology.

I. Separate Liability Allocation and Capehart Estate Methodology

We begin with an overview of separate liability allocation.

Generally, taxpayers filing joint Federal income tax returns are

jointly and severally liable for all taxes due. See sec.

6013(d)(3). A spouse (requesting spouse) may elect to have the

liability limited to his or her proportionate share of the

liability, however, if the spouses are divorced, legally

separated, or living apart for the 12 months preceding the

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[5]Respondent's proposed computations result in allocated penalties of $369.50 for 1994, $791.60 for 1995 and $394.90 for 1996.

[6]Petitioner's proposed computations result in allocated penalties of $25.15 for 1994, zero for 1995 and zero for 1996.

election. Sec. 6015(c)(1), (3)(A)(i). The separate liability

allocation must be made no later than two years after the

Secretary has begun collection activities with respect to the

electing spouse. Sec. 6015(c)(3)(B).

Liability allocation is based on the items that gave rise to

the deficiency (erroneous items). Erroneous items are allocated

to each spouse as though each had filed a separate return for the

taxable year, subject to some exceptions. Sec. 6015(d)(3)(A).

Erroneous items are reallocated under the tax benefit exception

to the extent one spouse received a tax benefit on the joint

return and the other spouse did not. Sec. 6015(d)(3)(B). The

requesting spouse's proportionate share of the deficiency is

based on his or her proportionate share of the erroneous items.

See sec. 6015(d)(1), (3)(A); sec. 1.6015-3(d)(4)(i)(A), Income

Tax Regs.

The requesting spouse's allocable share of the accuracy-

related penalty is based on his or her allocable share of the

underpayment. Sec. 1.6015-3(d)(4)(iv)(B), Income Tax Regs. The

underpayment is reduced, however, by the requesting spouse's

share of excess withholding credits, estimated tax payments, and

other payments that were frozen by the Commissioner instead of

being refunded to the taxpayer. See sec. 6664(a); Sec. 1.6664-

2(a), (d), Income Tax Regs. The requesting spouse's share of the

underpayment is then multiplied by 20 percent to determine his or

her allocable share of the accuracy-related penalty. Capehart
Estate, supra at 225-226.

II. Applying the Computational Adjustments

We now turn to the parties' proposed computations of
petitioner's separate liability allocation. Petitioner claims
that the amount of the liability should be the same regardless of
whether the computational adjustments are made in one step or
multiple steps. He analogizes the assessment of computational
adjustments in TEFRA proceedings to the computation of tax
deficiencies to support his claim. We note, however, that normal
deficiency procedures do not apply to computational adjustments.
Sec. 6230(a)(i); see sec. 6230(a)(2)(A). We do not find
petitioner's analogy helpful.

Petitioner's proposed computations also ignore the
partnership procedures set forth in TEFRA. See secs. 6221
through 6231. The TEFRA rules provide for separate proceedings
at the partner and partnership levels. See GAF Corp. & Subs. v.
Commissioner, 114 T.C. 519, 524 (2000). The computational
adjustments at issue stem from separate partner and partnership
level proceedings. The Tier 1 computational adjustments are
partnership-level adjustments and the Tier 2 computational
adjustments are partner-level adjustments of Tier 1 partnership
items. Accordingly, the TEFRA rules require that the Tier 1

partnership-level computational adjustments be made separate from
the Tier 2 partner-level computational adjustments.

Petitioner's proposed computations also ignore the 1-year
limitation on making computational adjustments. See sec.
6229(a), (d). Decisions were finalized in the Tier 1 partnership
proceedings in 2005, or almost a year before the decisions were
finalized in the Tier 2 partnership proceedings. The Tier 1
computations must therefore be made before the Tier 2
computations to comply with the Tier 1 limitations period.

III. Applying the Capehart Estate Methodology

We now turn to the application of the Capehart Estate
methodology to make the separate liability allocation. We have
already determined that the Tier 1 and Tier 2 computations for
each taxable year should be made separately and the Tier 1
computations should be made first. The Capehart Estate
methodology should also be applied separately to each set of
computations. This means that the tax benefit exception should
be applied twice. The tax benefit exception should be applied
once at the Tier 1 partnership level and again at the Tier 2
partnership level.

Petitioner's proposed computations, however, apply the tax
benefit exception only to the Tier 1 erroneous items and ignore
the tax benefits petitioner received from the Tier 2 Hoyt income
and partnership losses. We find that respondent's proposed

computations properly apply the tax benefit exception separately to the Tier 1 and Tier 2 erroneous items.

IV. <u>Allocation of the Penalties</u>

We now turn to the allocation of the penalties. We find that the accuracy-related penalties, which are based on the Tier 1 and Tier 2 underpayments, must also be separately allocated for each set of computations. We further find that respondent's computations properly account for frozen refunds before separately allocating the Tier 1 and Tier 2 penalties.

In reaching our holding, we have considered all arguments made, and, to the extent not mentioned, we conclude that they are moot, irrelevant, or without merit.

<u>An appropriate order will be issued</u>.